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Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

ROBERT ORMAN, ***Petitioner,***
v.
CHARLES E. SCHWAB & CO., INC., ***Respondent.***

GORDON RUBENSTEIN, ***Petitioner,***
v.
QUICK & REILLY, INC., and
U.S. CLEARING CORP., ***Respondents.***

LEONARD M. BLAND, ***Petitioner,***
v.
OLDE DISCOUNT CORPORATION, ***Respondent.***

On Petition for Writ of Certiorari to the Supreme Court of Illinois

PETITION FOR WRIT OF CERTIORARI

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60 pp

QUESTION PRESENTED

Do federal securities laws pre-empt state common law damage remedies for a broker's breach of the fiduciary duty of loyalty to customers where state law is not inconsistent with federal law requirements?

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OPINIONS BELOW

The decision of the Illinois Supreme Court is not yet officially reported. It is reproduced in the Appendix to this Petition for Writ of Certiorari ("App.") at 1. The Illinois Appellate Court decision in *Orman v. Charles Schwab & Co., Inc.* is reported at 676 N.E.2d 241 (1st Dist. 1996) (App. 17). The decisions of the Chancery Court of Cook County (App. 36, 37) are not officially reported.

JURISDICTION

The Illinois Supreme Court filed its opinion and entered judgment on November 20, 1996. (App. 1). This Petition for Writ of Certiorari is filed pursuant to Supreme Court Rule 13. This Court has jurisdiction pursuant to 28 U.S.C. § 1257(a).

STATUTES AND REGULATIONS INVOLVED

This Petition for Writ of Certiorari raises the question whether the 1934 Securities Exchange Act, as amended, and regulations of the Securities and Exchange Commission pre-empt fiduciary duty common law remedies available to investors. Due to their length, the statutes and regulations involved are reproduced in pertinent part in the Appendix. (App. 38). These statutes and regulations are as follows:

1. The Supremacy Clause of the United States Constitution, Article VI, clause 2.
2. Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb.
3. Rule 10b-10, Confirmation of Transactions, 17 C.F.R. § 240.10b-10 (promulgated 1977).

4. Rule 10b-10, Confirmation of Transactions, 17 C.F.R. § 240.10b-10 (amended 1994).
5. Rule 11 Ac1-3, 17 C.F.R. § 240.11Ac1-3 (adopted November 2, 1994).

STATEMENT OF THE CASE

Petitioners Robert Orman, Gordon Rubenstein and Leonard Bland, individually and on behalf of customers of defendant brokers, each commenced a class action in the Circuit Court of Cook County, Illinois. Plaintiffs alleged that the defendant stockbrokers breached fiduciary duties and contracts by directing customer orders for execution to market makers who pay the brokers for sending their business to them. In violation of state law, the brokers neither disclosed this practice in advance, nor passed on these payments to their customers. The complaints seek to recover as damages the payments the brokers received for sending plaintiffs' stock trades to market makers who paid for the business.

The brokers call these payments "payment for order flow", although the payments have been characterized as "kickbacks" by those questioning their legality. Although we adopt here the brokers' terminology and refer to these payments as "payments for order flow", this does not alter the conflict the practice at issue creates for brokers, who act as an agent for a customer in executing the customer's order while aggregating customer orders for which they receive compensation from a market maker.

The practice of stockbrokers taking cash payments for directing customer orders to particular market makers

began in the 1980's. At the time, there was no SEC rule or regulation that mentioned this practice. In the mid-1980's, however, the National Association of Securities Dealers ("NASD") recommended to its members that stockbrokers should treat payments for order flow as "other remuneration" and disclose the payments on the back of their confirmation slips in accordance with SEC Rule 10b-10(a)(7)(iii).[1] Rule 10b-10 did not mention payment for order flow; and the SEC had not addressed the practice. Moreover, in announcing Rule 10b-10 in 1977, the SEC made clear that "[t]he Rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities." Securities Exchange Act Release No. 13,508 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143, at 87,930 n. 28 (May 5, 1977). When plaintiffs commenced these actions in 1993, the SEC had not announced any rule governing payments for order flow.

A. Statutory and Regulatory History

In 1934, Congress enacted the Securities Exchange Act ("Exchange Act"), among other things, to implement a philosophy of full disclosure. By expressly preserving rights and remedies that existed under state law, Con-

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[1] The SEC promulgated Rule 10b-10 in 1977 to address the problem of "agency crosses in the over-the-counter market where the broker acts as agent for both the buyer and the seller." Securities Exchange Act Release No. 13,508 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143 (May 5, 1977). Rule 10b-10 requires brokers to disclose on their confirmation slips whether they are receiving other remuneration. (App. 38).

gress made clear that state laws would continue to govern securities industry participants. Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a) provides: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist in law or in equity." Since 1934, Congress has not suggested that the federal securities laws generally pre-empt state law fiduciary duties of an agent to act in its customer's best interests.[2]

In 1975, Congress amended the Exchange Act and reiterated the Act's basic goals, including fair dealing in securities and assuring that each investor obtained the best possible execution of his order. Senate Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. (1975). The 1975 amendments also directed the SEC to facilitate the establishment of a national market system in accordance with the Exchange Act's objectives.

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[2] Indeed, in only one instance has Congress modified general common law fiduciary duties. In the 1975 amendments, Congress created a safe harbor for a fiduciary money manager, who, in the exercise of investment discretion with respect to an account, paid higher commissions to broker-dealers who provided brokerage or research services. Congress added Section 28(e) of the Exchange Act that pre-empted then-existing state or federal law that made such conduct a *per se* breach of fiduciary duty. Congress allowed such conduct so long as the manager determined the commission was in the investor's best interest and adequately disclosed his policies and practices with respect to commission payments. 15 U.S.C. § 78bb(e). This modification of state common law is not applicable here, but is significant because, in limiting state law fiduciary duty, this provision expressly recognized that state fiduciary duty law would otherwise have applied to such transactions and left room for state law regulation both in the future and where the manager did not act in his customer's best interests.

The SEC has repeatedly and consistently acknowledged the central role of state fiduciary duty law in regulating broker dealer conduct toward customers. Indeed, the SEC has noted that "[o]rdinarily, a fiduciary that uses the assets of its managed accounts for its own benefit would be subject to claims of a breach of fiduciary duty under state and federal law." Securities Exchange Act Release No. 34-30920, U.S. Equity Market Structure Study [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,012, at 82,908 n. 7 (July 14, 1992). And, the SEC has relied on common law agency principles (RESTATEMENT (SECOND) OF AGENCY, § 387 and § 424) in stating that a broker's duty to customers comes from the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest. SEC Division of Market Regulation, "Market 2000: An Examination of Current Equity Market Developments," Study V, Best Execution (Jan. 1994).

In 1992, the SEC noted concern that the practice of order flow payments would interfere with the execution of customer orders and the fiduciary duty to obtain the best execution of a customer trade: "the practice raises the concern that a broker's decision on how to execute a customer's order is influenced by the payment of compensation by particular markets or market makers." Securities Exchange Act Release No. 34-30920, *supra*, at 82,919 (July 14, 1992).[3] In 1994, the SEC responded by

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[3] In 1993, the SEC sought a fuller debate on a proposed rule to require enhanced disclosures regarding payment for order flow or alternatives, including prohibiting payment for order flow. Securities Exchange Act Release No. 33026 (Oct. 6, 1993), 58 FR 52934 (Oct. 13, 1993). The SEC again recognized

(continued...)

prospectively imposing a new disclosure requirement on brokers to inform their customers before opening an account and annually afterwards of their policies and practices with respect to payment for order flow.[4] The Commission thereby provided brokers with a way to eliminate—with respect to future transactions—the broker's conflict and exposure to claims for breach of the fiduciary duty of loyalty by requiring disclosure to, and consent of, a customer before a broker can accept payments in exchange for directing its customer's orders to a market maker. This case concerns exclusively *pre*-1994 events which are not governed by the SEC's new rule.

B. Proceedings in the Illinois Courts

After plaintiffs filed their complaints in the Circuit Court, the defendants moved to dismiss each complaint, contending that the federal securities laws pre-empted plaintiffs' claims. Both trial court judges granted defendants' motions and plaintiffs appealed. The three com-

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[3] (...continued)
that the availability of payments in return for order flow may color a broker's evaluation of the best opportunity for its customer and cited concerns that the acceptance of such a payment may be a breach of fiduciary duty. *Id.*

[4] The SEC amended Rule 10b-10 to include for the first time an express reference to and definition of "payment for order flow" and adopted new Rule 11Ac1-3 which requires brokers to inform their clients "in writing, upon opening a new account and on an annual basis thereafter," of their policies regarding payment for order flow, including "a detailed description of the nature of the compensation received" and "policies for determining where to route customer orders that are the subject of order flow." Rule 11Ac1-3, 17 C.F.R. § 240.11Ac1-3 (App. 40-41).

plaints were consolidated for purposes of appeal. On December 24, 1996, a majority of the Illinois appellate court affirmed, relying on decisions in similar actions brought in other state courts that state law claims are pre-empted.[5] The majority held that allowing plaintiffs' claims to survive would frustrate, if not destroy, the "federal goal" of "uniform" regulation of the securities markets. (App. 29). In a dissenting opinion, one justice of the appellate court concluded that, although federal law provided minimum disclosure requirements, nothing in the federal securities laws could prevent the plaintiffs from bringing actions for breach of fiduciary duty against agents who had secretly received and retained money from those to whom they sent their principals' business. (App. 31).

The Illinois Supreme Court allowed plaintiffs' petition for leave to appeal and, in an opinion issued on November 20, 1997, affirmed the appellate court's decision. The Illinois Supreme Court held that allowing plaintiffs' breach of fiduciary duty claims to proceed would obstruct Congress' intent to foster a National Marketing System by subjecting brokers to damages claims for breaches of state law fiduciary duties that were not expressly contained in the federal securities laws. The Illinois Supreme Court reasoned that: (1) Congress amended the Exchange Act in 1975 to increase competi-

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[5] *Dahl v. Charles Schwab & Co., Inc.*, 545 N.W.2d 918 (Minn.), *cert. denied*, 117 S.Ct. 176 (1996); *Guice v. Charles Schwab & Co., Inc.*, 89 N.Y.2d 31, 651 N.Y.S.2d 352, 674 N.E.2d 282 (1996), *cert. denied*, 117 S.Ct. 1250 (1997); *McKey v. Charles Schwab & Co., Inc.*, No. BC139314 (Cal.Super. Ct. Sept. 10, 1996); *Miller v. Charles Schwab & Co.*, No. BC137133 (Cal.Super.Ct. Sept. 10, 1996).

tion in the securities industry; (2) the SEC had determined that order flow payments overall had a positive competitive effect; and (3) the SEC in 1994, after the transactions of which plaintiffs complain, had adopted regulations that require brokers to disclose the practice of receiving order flow but not to pass through or disclose the amount of payments to customers. The court concluded that plaintiffs' damages claims were, therefore, pre-empted because they would require individualized apportionment that the SEC did not require. The decision of the Illinois Supreme Court is the subject of this petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

The Illinois Supreme Court has decided an important question of federal pre-emption in a way that directly conflicts with relevant decisions of this Court and that contravenes Congress' intent as expressed in the "savings clause" of Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a). Moreover, the highest state courts of New York and Minnesota, on which the Illinois court relied, have also ignored the express language of Section 28(a) and have construed the doctrine of implied pre-emption in a way that sweeps aside state fiduciary duty laws.

Congress enacted the Securities Exchange Act of 1934 to promote disclosure to investors in the federal securities markets. In the Exchange Act, Congress made explicit its intention not to pre-empt the role of the states. When Congress amended the Exchange Act, it reaffirmed that it did not intend the federal securities laws to pre-empt state common law remedies. Section

28(a) of the Exchange Act provides: "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." As this Court has long recognized, "The section was plainly intended to protect, rather than to limit, state authority." *Leroy v. Great W. United Corp.*, 443 U.S. 172, 182 (1979). *See also, Matsushita Elec. Indus. Co. v. Epstein*, 116 S.Ct. 873, 882 (1996).

One well established area of state authority that Section 28(a) was designed to protect is the common law fiduciary duties of loyalty and disclosure, which require an agent to make full disclosure to the principal and act exclusively in the principal's best interest. RESTATEMENT (SECOND) OF AGENCY § 387 (1958). Payment for order flow implicates these duties. The broker's dual role, as both agent for the customer and an aggregator of customer orders for which the broker receives compensation from a market-maker, creates a conflict. The defendant brokers in this case profited from, but did not disclose, this conflict to their customers.

The Illinois Supreme Court concluded that, because the SEC had not banned payment for order flow or required brokers to disclose the amount of order flow payments received, plaintiffs' state law breach of fiduciary duty claims were pre-empted. The Illinois court reasoned that to allow these claims would frustrate Congress' intent, as reflected in the 1975 Amendments to the Exchange Act, to further a National Market System. This conclusion is wholly erroneous and should be re-examined. It elevates Congressional and regulatory silence to a position superior to Congress' explicit intent as evidenced in a statutory provision, namely Section 28(a), 15 U.S.C. § 78bb(a).

It is well-established that state laws are not pre-empted simply because they impose obligations that go beyond federal law and govern areas of behavior about which Congress has been "silent." *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 77 (1987); *Atherton v. F.D.I.C.*, 117 S.Ct. 666, 670 (1997). Only last term, this Court recognized that conduct that is not prescribed by Section 10(b) of the Exchange Act may still subject a securities trader to liability under state law for breach of a duty of loyalty. *United States v. O'Hagan*, 117 S.Ct. 2199, 2209 (1997).

Nothing in the Exchange Act itself suggests Congress intended federal silence on matters of potential securities law regulation to displace state common law breach of fiduciary duty claims. *See, e.g., United States v. O'Hagan, supra*. And any attempt to read pre-emption into a statute that contains a sweeping savings clause turns on its head this Court's recognition that "the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear intent of Congress." *Medtronic, Inc. v. Lohr*, 116 S.Ct. 2240, 2250 (1996), quoting from *Rice v. Sante Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

Moreover, nothing in the language or context of SEC regulations pre-empts plaintiffs' claims. No SEC regulations before 1994 mentioned payment for order flow. The fact that securities industry participants chose to construe Rule 10b-10, regarding information to be included on confirmations, to be applicable to order flow payments does not, without more, relieve brokers from liability for breach of fiduciary duty. Nothing in Rule 10b-10 purports to satisfy a broker's obligations under state fiduciary duty law, and the after-the-fact disclo-

sure on the back of a confirmation is not the kind of full disclosure necessary to obtain consent to conduct that would otherwise be a breach of the duty of loyalty or the duty of full disclosure.[6] The SEC itself stated at the time it announced Rule 10b-10: "The rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities." Securities Exchange Act Release No. 13,508 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,143, at 87,930 (May 5, 1977). Similarly, the Rule is not a "safe harbor" that defines the full extent of a broker's fiduciary duties to its customers.

In 1994, the SEC responded to the practice of payment for order flow by requiring brokers to disclose to a customer in advance the policies regarding payment for order flow, including the nature and source of the compensation, and the broker's policies for determining where to route customer orders. As the SEC acknowledged at the time, this approach is consistent with the overall philosophy of federal securities laws that "sunlight is the best disinfectant." Securities Exchange Act Release No. 34-34902, quoting L. Brandeis, *Other People's Money and How the Bankers Use It,* 92 (Frederick

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[6] See Note, *The Perils of Payment for Order Flow*, 107 Harv. L. Rev. 1675, 1685 (May 1994) (disclosures on confirmation slips do not justify broker retention of order flow payments because "the vague, small-print disclosure required by Rule 10b-10 does not adequately alert customers to the presence of payments for order flow" and "ex-post acquiescence is not the ex-ante agreement that agency law seems to mandate before the agent can keep profits derived from a transaction on behalf of his principal").

A. Stokes Co. ed. 1932). This response, however, does not in any way diminish plaintiffs' claims because the misconduct complained of here occurred before the SEC announced its Rule and because plaintiffs' claims are based on defendants' failure to make the advance disclosure that agency law (and now the SEC) mandates. Moreover, the SEC's response does not lessen the importance of the issue this case raises of courts' limiting traditional state court remedies despite a broad savings clause in a federal statute expressly preserving these remedies.[7]

The Illinois Supreme Court's decision rests on the serious misconception that state law is pre-empted because federal law does not require brokers to disclose the amount of the order flow payments they receive, yet plaintiffs' state law damage claims would require these amounts to be computed. But a Congressional intent to pre-empt a traditional state law remedy cannot be implied simply because the SEC, years after the fact, decided not to require precise calculations. The Illinois court's reading of Congressional intent is contrary to common sense. More importantly, this Court has long recognized that it is "difficult to believe that Congress would, without comment, remove all means of judicial recourse for those injured by illegal conduct." *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 251 (1984). This,

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[7] Contrary to the state court decisions, two federal district courts have considered the issue of payment for order flow and have held that federal law does not pre-empt customers' common law claims. *Thomas v. Charles Schwab & Co.*, 1995 U.S. Dist. LEXIS 12007 (W.D. La. July 12, 1995); *Dumont v. Charles Schwab & Co.*, 1995 U.S. Dist. LEXIS 5992, 1995 WL 262262 (E.D. La. May 3, 1995).

however, is precisely what the Illinois court has done. It has decided that Congress, without comment, wiped out an entire area of state law which has traditionally been sacrosanct. If allowed to stand, the decision of the court below would deprive investors of their traditional right to recover from a broker who has breached his fiduciary duty.

CONCLUSION

Petitioners respectfully ask this Court to issue a Writ of Certiorari in order to resolve the important questions of federalism and pre-emption raised by the decision of the Illinois Supreme Court.

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IN THE
SUPREME COURT OF ILLINOIS

Docket No. 82697-Agenda 26-September 1997

ROBERT ORMAN *et al.*, Appellants,
v. CHARLES SCHWAB &
COMPANY, INC., *et al.*, Appellees.

November 20, 1997, Opinion Filed

JUSTICE HEIPLE delivered the opinion of the court:

At issue is whether Illinois breach of fiduciary duty and breach of contract claims arising out of a broker's retention of order flow payments are implicitly preempted because such claims would stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress in enacting the Securities Exchange Act of 1934 (15 U.S.C. § 78a *et seq.* (1994)). The plaintiffs in the three class action lawsuits consolidated for review sued the broker-defendants for retaining order flow payments, which they contend runs afoul of Illinois agency law. The trial court granted defendants' motions to dismiss plaintiffs' complaints on the ground that their claims were preempted by the Securities Exchange Act of 1934, and the appellate court affirmed (285 Ill. App. 3d 937). This court allowed plaintiffs' petition for leave to appeal (166 Ill. 2d R. 315). For the reasons expressed below, we affirm.

ANALYSIS

The plaintiffs in these consolidated class actions assert the rights of a putative nationwide class of customers of

defendants, Charles Schwab & Company, Inc., Quick and Reilly, Inc., and Olde Discount Corporation, discount securities brokerage firms which plaintiffs retained to execute their securities transactions. The gravamen of plaintiffs' complaints is that the defendants violated Illinois agency and/or contract law when they failed to remit to plaintiffs order flow payments received in executing plaintiffs' securities transactions. Order flow payments consist of both monetary and nonmonetary remuneration paid to a dealer by a market maker in exchange for the dealer's routing a customer's orders through the market maker. As plaintiffs observe, brokers are their customers' agents and as such owe them certain fiduciary duties. See *Martin v. Heinold Commodities, Inc.*, 117 Ill. 2d 67, 76-77 (1987). Under traditional agency law, an agent who makes a profit in connection with transactions conducted on behalf of the principal is under a duty to remit that profit to the principal absent an agreement to the contrary. *Janes v. First Federal Savings & Loan Ass'n*, 57 Ill. 2d 398, 410 (1974), quoting Restatement (Second) of Agency § 388 (1958). Plaintiffs' complaints allege breach of fiduciary duty and breach of contract premised upon defendants' failure to remit the order flow payments they received to the plaintiffs.[1]

Defendants counter that the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. § 78a *et seq.* (1994))

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[1] At oral argument, plaintiffs claimed for the first time that one or more of the defendants may not have complied with Securities and Exchange Commission Rule 10b-10. 17 C.F.R. § 240.10b-10(a)(7)(iv) (1997). Insofar as this issue was not raised in the lower court proceedings, or briefed before this court, it is waived.

implicitly preempts plaintiffs' state-law claims. The preemption doctrine is rooted in the supremacy clause of the United States Constitution, which mandates that "the Laws of the United States *** shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const., art. VI, cl. 2. An act of Congress or regulatory law promulgated thereunder may supersede the statutory, regulatory or common law of any state where such "[is] the clear and manifest purpose of Congress." *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516, 120 L. Ed. 2d 407, 422, 112 S. Ct. 2608, 2617, quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230, 91 L. Ed. 1447, 1459, 67 S. Ct. 1146, 1152 (1947). A congressional act can either expressly or implicitly preempt a state cause of action. *Freightliner Corp. v. Myrick*, 514 U.S. 280, 287, 131 L. Ed. 2d 385, 392, 115 S. Ct. 1483, 1487 (1995). Here defendants urge that plaintiffs' state claims relating to order flow payments are implicitly preempted by the Exchange Act because they "stand[ ] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," as manifested in the language, structure and underlying goals of the statute at issue. See *Hines v. Davidowitz*, 312 U.S. 52, 67-68, 85 L. Ed. 581, 587, 61 S. Ct. 399, 404 (1941).

Determining whether plaintiffs' state-law claims are implicitly preempted by the Exchange Act requires an understanding of the Exchange Act's history and the evolution of order flow payments. Congress enacted the Exchange Act in 1934 to regulate the various aspects of the securities industry; its implementing agency, the Securities and Exchange Commission (SEC), is responsi-

ble for adopting regulations which foster capital formation, facilitate competition and protect investors in the vastly complex array of markets that constitute the securities industry. Congress subsequently enacted amendments to the Exchange Act in 1975 (1975 Amendments) to cure "the securities industry's languor in the face of great changes and opportunities." S. Rep. No. 94-75, at 1, *reprinted in* 1975 U.S.C.C.A.N. 179, 180. Concerned with the misallocation of capital, widespread inefficiencies, and undesirable and potentially harmful fragmentation of trading (S. Rep. No. 94-75, at 1, reprinted in 1975 U.S.C.C.A.N. 179, 180), the 1975 Amendments called upon the SEC to develop a "National Market System" which would facilitate the "economically efficient execution of securities transactions" and "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets." 15 U.S.C. §§ 78k-1(a)(1)(C)(i), (a)(1)(c)(ii) (1994).

The SEC's responsibilities included implementing regulations to "assure the prompt, accurate, reliable, and fair collection *** [and] distribution *** of information with respect to *** transactions in such securities and the fairness and usefulness of the form and content of such information." 15 U.S.C. § 78k-1(c)(1)(B) (1994). In 1977, the SEC exercised its authority and adopted Rule 10b-10, a "uniform rule applicable to all who wish to effect transactions for or with investors" which "adjust[ed] regulatory requirements to eliminate those for which compliance costs appear to be disproportionate to the practical benefits of investor protection thereby obtained." (Securities Confirmations Proposed Rule, SEC Exchange Act Release No. 12806, *reprinted in* 41 Fed.

Reg. 41,432, 41,432 (1977)). In pertinent part, Rule 10b-10 required that a broker-dealer disclose on a customer's confirmation statement "whether any other remuneration has been or will be received and that the source and amount of such other remunerations will be furnished upon written request." 17 C.F.R. § 240.10b-10(a)(7)(iv) (1997). Rule 10b-10 was in addition to section 28(a) of the 1975 Amendments, which provided in pertinent part:

> "The rights and remedies provided by this chapter shall be in addition to any and all other rights that may exist at law or in equity ***. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any state over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." 15 U.S.C. § 78bb(a) (1994).

Thus Congress and the SEC achieved the appropriate balance between necessary regulation and free market forces in advancing the National Market System.

Substantively, the 1975 Amendments contained a variety of provisions intended to increase the number of market participants, develop competitors to the traditional stock exchanges and utilize emerging technology to increase competition between the exchanges and market makers for retail customer order flow. Market 2000: An Examination of Current Equity Market Developments, Market Regulation Division, Securities and Exchange Commission 5-6 (1994). It was hoped that "[i]f market makers in a particular market center have reasonable expectations that they will receive a greater amount of [customer] order flow if they make markets

which are consistently better in terms of price, depth or ease of execution *** they will be more likely to compete aggressively thereby providing a better and more efficient" National Market System. Development of a National Market System, Exchange Act Release No. 34-15671, Fed. Sec. L. Rep. (CCH) par. 81,572 (1979). Toward this end, the 1975 Amendments abolished fixed commission rates in order to increase competition within and between securities markets. See 15 U.S.C. § 78(e)(1) (1994).

The 1975 Amendments have been successful, prompting market makers to develop and utilize nontraditional markets such as the over-the-counter (OTC) market and the NASDAQ to effectuate trades, which has in turn has increased customer options with respect to how and at what prices they trade securities. Integral to the market makers' ability to attract steady streams of customer order flow for traditional and nontraditional markets has been the practice of paying "order flow payments." Generally speaking, payment for order flow is the practice of market makers or exchange specialists compensating brokerage firms for directing customer orders to them for execution. The order flow payment practice evolved in the early 1980s and typically includes both monetary and nonmonetary remuneration to broker-dealers in exchange for their routing their customers' transactions through the market makers.[2] When the

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[2] Examples of order flow payments include: cash payments; reciprocal order-routing relationships; discounts; credit; and free services such as access to industry analysts' reports; accommodation and adjustments of trading errors; access to

(continued...)

practice of order flow payments evolved, the National Association of Securities Dealers took the position that the practice was governed by Rule 10b-10, the 1977 all-purpose provision requiring that broker-dealers disclose on a customer's confirmation statement whether any other remuneration has been or will be received and that the source and amount of such other remunerations will be furnished upon written request. 17 C.F.R. § 240.10b-10(a)(7)(iv) (1997). See, *e.g.,* National Association of Securities Dealers Notice to Members, NTM No. 85-32 (1985) (Rule 10b-10 applies to "payments received by a retail firm from a market maker in return for their directing order flow to the market maker").

As evidenced by the instant plaintiffs' persistent references to order flow payments as "kickbacks," the practice has its detractors. See generally Note, *The Perils of Payment for Order Flow*, 107 Harv. L. Rev. 1675 (May 1994). The SEC, sensitive to the various concerns raised by the practice, has studied its impact on both markets and consumers since as early as 1984. See SEC Release No. 34-33026, *reprinted in* 58 Fed. Reg. 52,934, 52,935 (1993). After a thorough and comprehensive study of order flow payments, with input from participants industrywide, the SEC acknowledged arguments that order flow payments produced economic benefits to customers, including: (1) lower unit costs; (2) increased retail brokerage firm revenue; (3) lowered

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[2] (...continued)
specialists proprietary order flow; reduced clearing charges; and participation in public offerings. Inducements for Order Flow, A Report to the Board of Governors, National Association of Securities Dealers, Inc., 15-20 (1991).

commissions; (4) more expeditious executions; (5) enhanced customer services; (6) increased competition from automated execution systems and related practices; (7) increased competition between wholesale dealers and exchanges and vertically integrated firms; and (8) reduced execution costs in all markets, including the exchanges. SEC Release No. 34-33026, *reprinted in* 58 Fed. Reg. at 52,939-40 (1993). Notwithstanding the far-reaching benefits identified, the SEC also recognized that order flow payments raise concerns as to whether the customer is being treated fairly. Payment for Order Flow, SEC Release No. 34-3026, at 24-26, *reprinted in* 59 Fed. Reg. 55,006 (1994).

Accordingly, in 1994 the SEC struck a deliberate balance: formulating disclosure requirements that provide investors with relevant, important information at key points, while at the same time avoiding impractical and burdensome disclosure requirements that might compromise the contributions of the practice to market competition. Specifically, on October 24, 1994, the SEC promulgated an amendment to Rule 10b-10 which, in pertinent part, added paragraph (9)(e), which defined order flow payments, and subparagraph (a)(7)(iii), which required disclosure of order flow at time of confirmation. In addition, the SEC promulgated Rule 11Ac1-3, which required disclosure of the practice of order flow payments at the time an account is opened and annually thereafter. SEC Release No. 34-34902, *reprinted in* 59 Fed. Reg. 55,006, 55,007-11 (1994). Finally, the SEC delayed implementation of the new rules "to provide firms with four months to make the necessary systems and forms changes to prepare for the implementation"; this initial four-month "safe harbor" was extended an additional seven months

until October of 1995 in further acknowledgment of the complex system changes that the additional disclosure rules necessitated. See Payment for Order Flow, SEC Release No. 35473, Fed. Sec. L. Rep. (CCH) par. 85,606, at 86,410 (March 10, 1995).

Significantly, the SEC rejected proposals that order flow payments be passed through to the customers. SEC Release No. 34-34902, *reprinted in* 59 Fed. Reg. at 55,011 n.42 (1994). Moreover, the SEC likewise rejected as unworkable its initial proposal that brokers disclose the *amount* of remuneration received in exchange for order flow. SEC Release No. 34-34902, *reprinted in* 59 Fed. Reg. at 55,010 n.39 (1994).

The order flow payments at issue in plaintiffs' complaints all took place prior to the SEC's 1994 promulgation of the Rule 10b-10 amendments and Rule 11Ac1-3. Plaintiffs contend defendants are liable to them under state agency law notwithstanding that defendants complied with the 1977 version of Rule 10b-10 by providing plaintiffs with confirmation slips apprising them that remuneration may have been received from the brokers through whom their transactions were executed and that, upon request, the amounts would be disclosed. Plaintiffs argue that defendants' compliance with Rule 10b-10 cannot be invoked to preempt their state-law claims because the practice of order flow payments was not even in existence at the time the rule was promulgated. Additionally, plaintiffs observe that Rule 10b-10 was not intended as a safe harbor against state laws which exceeded its requirements; rather, Rule 10b-10 was intended to prescribe only minimum disclosure obligations. *Ettinger v. Merrill Lynch, Pierce, Fenner &*

Smith, Inc., 835 F.2d 1031, 1034 (3d Cir. 1987), quoting Securities Exchange Act Release No. 13,508, Fed. Sec. L. Rep. (CCH) par. 81,143, at 87,930 n.28 ("'[t]he rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities'"). Accordingly, plaintiffs contend that additional disclosure requirements that complement Rule 10b-10 and provide added security to customers are entirely consistent therewith and are not preempted. *Cf. CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 77, 95 L. Ed. 2d 67, 77, 107 S. Ct. 1637, 1643 (1987) (Indiana statute containing stricter takeover requirements did not conflict with the Williams Act); *American Airlines, Inc. v. Wolens*, 513 U.S. 219, 130 L. Ed. 2d 715, 115 S. Ct. 817 (1995) (establishing that a plaintiff may pursue a breach of contract claim against airline despite the existence of a comprehensive federal regulatory scheme governing the industry).

Though plaintiffs are correct that the practice of order flow payments had not commenced until several years after Rule 10b-10 was adopted, it nevertheless remains true that Rule 10b-10 is of general application and clearly encompassed the practice when it evolved. Rule 10b-10 required brokers to include on a customer's confirmation statement whether any other remuneration has been or will be received and that the source and amount of such other remunerations will be furnished upon written request. 17 C.F.R. § 240.10b-10(a)(7)(iv) (1997). Order flow payments are "other remuneration" and as such are governed by Rule 10b-10. Equally unavailing is plaintiffs' observation that Rule 10b-10 sets forth only minimum guidelines and was not intended as

a safe harbor for those who do not meet more rigorous state disclosure laws. The preemption issue at bar must be decided upon careful consideration of congressional and SEC intent, of which Rule 10b-10 is only a partial manifestation.

Similarly inconclusive is plaintiffs' reliance on section 28(a) of the Exchange Act as evidence of Congress' intention to permit their state causes of action. Section 28(a) provides:

> "The rights and remedies provided by this chapter shall be in addition to any and all other rights that may exist at law or in equity ***. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any state over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder." *15 U.S.C. § 78bb*(a) (1994).

Because section 28(a) expressly acknowledges that state and federal securities laws may coexist, and further that no provision of the Exchange Act or the SEC's implementing regulations expressly prohibit application of state agency law to broker-customer relationships, plaintiffs contend there can be no implicit preemption. See *Leroy v. Great Western United Corp.*, 443 U.S. 173, 182, 61 L. Ed. 2d 464, 473, 99 S. Ct. 2710, 2716 (1979) (section 28(a) was intended to protect, rather than limit, state authority); *Matsushita Electric Industrial Co. v. Epstein*, 516 U.S. 367, 134 L. Ed. 2d 6, 116 S. Ct. 873 (1996) (Congress contemplated the possibility of dual litigation in state and federal courts related to securities transactions). Section 28(a), however, is of little assist-

ance in determining whether plaintiffs' state causes of action are preempted. For while it admittedly permits "the jurisdiction of the securities commission (or any agency or officer performing like functions) of any state over any security or any person," it does so only "*insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.*" (Emphasis added.) 15 U.S.C. § 78bb(a) (1994). As the Supreme Court elucidated in *Freightliner Corp. v. Myrick,* 514 U.S. at 288-89, 131 L. Ed. 2d at 393, 115 S. Ct. at 1488, a statutory preemption clause which preempts state laws that conflict with the federal law, but which also preserves nonconflicting state laws, does not foreclose the possibility of implied preemption. Even in such a situation, preemption may result where the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," as manifested in the language, structure and underlying goals of the statute at issue. See *Hines v. Davidowitz,* 312 U.S. 52, 67-68, 85 L. Ed. 581, 587, 61 S. Ct. 399, 404 (1941).

Thus we consider Congress' intent, as manifested both by the Exchange Act and the SEC rules and regulations promulgated thereunder. As detailed above, Congress enacted the 1975 amendments to the Exchange Act to counteract the languor of the then-existing securities industry and foster a new National Market System characterized by a more "economically efficient execution of securities transactions" and increased competition among all securities industry participants, including "between exchange markets and markets other than exchange markets." Pub. L. No. 94-29, § 7, 89 Stat. 97, 111-12 (1975); 15 U.S.C. § 78k-1(c)(1)(B) (1994). This

new market system was intended to address the malaise Congress perceived was emanating from lack of competition in the securities industry-an affliction. Congress sought to correct in advance of technological innovations it correctly anticipated would radically alter the securities industry, both nationally and internationally.

Throughout the 1980s and 1990s, the SEC studied order flow payments at length and determined, *inter alia*, that the practice had fueled the growth of nontraditional markets which had in turn led to industrywide reductions in commission rates, faster trade executions and enhanced services. Payment for Order Flow, SEC Release No. 34-3026, at 24-26 (1993). Nor can the impact of these nontraditional markets be overstated: from 1978 to 1992, the percentage of consolidated tape trades in NYSE stocks executed by the NYSE declined from 85.99% to 65.17%, while the percentage executed by the regional exchanges and NASDAQ climbed from 11.55% to 24.22%, and 2.39% to 10.57%, respectively. Market 2000: An Examination of Current Equity Market Developments, Market Regulation Division, Securities and Exchange Commission, Ex. 18 (1994).

In 1994, after much deliberation, the SEC amended Rule 10b-10 and promulgated Rule 11Ac1-3 to specifically address the practice of order flow payments. It thereby required that brokers apprise customers whether they engage in order flow payment practices at the time the account is first established and annually thereafter. Additionally, the confirmation slips must advise the customer that order flow payments were received in the course of effectuating a transaction and further advise the customer that, upon request, the *nature* of the re-

muneration will be disclosed. After careful study, the SEC determined that these disclosure requirements struck the appropriate balance between the need to protect consumers and the need to facilitate the increased competition and reduced commissions brought about by the practice of order flow payments.

Regarding the scope of the SEC's disclosure rules vis-a-vis the instant plaintiffs' state-law claims, the SEC's refusal to require brokers to pass through to customers or even disclose the amount of order flow remuneration in its 1994 disclosure promulgations is significant. See SEC Release No. 34-34902, *reprinted in* 59 Fed. Reg. at 55,010 n.39, 55,011 n.42 (1994). The SEC concluded that either requirement would be unworkable because a wide array of formulas are used in calculating order flow payments, many of which would be near impossible to apportion on an individual account basis; moreover, there are a variety of nonmonetary remunerations which, though their nature must be disclosed upon request, are not easily valued monetarily. Requiring such would effectively bring the practice of order flow payments to a halt, jeopardizing all direct and indirect benefits attributable to the practice. This the SEC refused to do.

Yet this is exactly what plaintiffs urge this court to sanction. Allowing plaintiffs to advance their breach of fiduciary duty and contract claims would require the defendants to identify the nature and calculate the value of order flow payments received so that plaintiffs' damages (the improperly retained order flow payments) could be assessed. Though the 1994 amendments were not in effect when the defendants retained the order

flow payments at issue, we believe these amendments are nevertheless instructive as to the scope of the 1977 version of Rule 10b-10. The deleterious effects to the National Market System that the SEC's 1994 amendments sought to avoid in allowing brokers to retain order flow payments and limiting the order flow disclosure requirements were no less a possibility prior to 1994, when the old Rule 10b-10 applied. Because the purposes and objectives of Congress in enacting the 1975 amendments to the Exchange Act, as well as those of the SEC in promulgating Rule 10b-10 in 1977, have remained constant, we believe what would be deleterious today would have been deleterious throughout the as-yet brief history of the National Market System. And, indeed, we observe that the high courts of New York (*Guice v. Charles Schwab & Co.*, 89 N.Y.2d 31, 674 N.E.2d 282, 651 N.Y.S.2d 352 (1996)) and Minnesota (*Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918 (Minn. 1996)) have so held, finding that claims substantially similar to the ones advanced by the instant plaintiffs are implicitly preempted because they interfere with goals of the Exchange Act. But see *Thomas v. Charles Schwab & Co.*, No. 95-0307 (W.D. La. July 12, 1995); *Dumont v. Charles Schwab & Co.*, No. 95-0606 (E.D. La. May 3, 1995) (ruling that similar claims are not preempted).

The supremacy clause requires that state law yield where it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," as manifested in the language, structure and underlying goals of the statute at issue. See *Hines v. Davidowitz*, 312 U.S. 52, 67-68, 85 L. Ed. 581, 587, 61 S. Ct. 399, 404 (1941). Given the history and purpose of

Congress' 1975 amendments to the Exchange Act as well as the SEC's implementing regulations vis-a-vis order flow payment disclosures, we are convinced that allowing plaintiffs' related state claims to advance would obstruct the National Market System that Congress intended to foster in enacting the 1975 Amendments. Accordingly, we affirm the judgment of the appellate court.

Appellate court judgment affirmed.

IN THE
APPELLATE COURT OF ILLINOIS
FIRST DISTRICT, SECOND DIVISION

Robert ORMAN, on Behalf of Himself and All Similarly Situated Schwab Customers, Plaintiff-Appellant,

v.

CHARLES SCHWAB & COMPANY, INC., Defendant-Appellee.

Gordon RUBENSTEIN, on Behalf of Himself and All Similarly Situated Quick and Reilly Customers, Plaintiff-Appellant,

v.

QUICK AND REILLY, INC., and United States Clearing Corporation, Defendant-Appellees.

Leonard M. BLAND, on Behalf of Himself and All Similarly Situated Olde Discount Corporation Customers, Plaintiff-Appellant,

v.

OLDE DISCOUNT CORPORATION, Defendant-Appellee.

Nos. 1-94-2277, 1-94-3423 and 1-94-3424.

Dec. 24, 1996.

JUSTICE RAKOWSKI delivered the opinion of the court:

Plaintiffs, Robert Orman, Gordon Rubenstein, and Leonard M. Bland (customers) filed complaints against defendants, Charles Schwab & Co., Quick & Reilly, Inc., and Olde Discount Corporation (brokers), respectively, alleging that brokers violated state common and statutory law when they conducted stock trades on behalf of customers. In particular, the brokers breached their fiduciary duties by keeping certain profits (order flow payments) without adequate disclosure to or authorization from the customers. Each suit was dismissed on the brokers' combination motions under sections 2-615 and 2-619 of the Code of Civil Procedure. 735 ILCS 5/2-615, 5/2-619 (West 1994). The trial court, in each case, found that the customers' claims were preempted by federal law. Plaintiffs appeal, contending the trial courts erroneously held that their actions were preempted. The cases were consolidated for appeal.

The sole issue is whether the customers' claims based on state common and statutory law are preempted by the Securities Exchange Act of 1934 (the Act) (15 U.S.C. § 78a *et seq.* (1994)). We affirm.

FACTS

As stated in the facts by the parties, pursuant to standard form contracts between the customers and brokers, each broker was employed to buy and/or sell stocks on the customers behalf, for which the broker would received a commission. In such capacity, the broker acted as the customer's agent. When a customer placed an order, the broker could execute it in various markets. The broker would contact a market maker of its choice to effectuate the required trade. The price

obtained was negotiated between the broker and the market maker. The market maker made a profit on every trade. To induce brokers to deal through them, market makers shared part of their profit with the brokers. This practice is known as order flow payments. It is a recognized and widespread practice in the industry and part of the competitive market.

Brokers retained the order flow payments and did not pass them on to customers. In their complaints, plaintiffs allege that the brokers breached their fiduciary duties by retaining the payments without adequate disclosure to them or authorization from them. Subsequent to each transaction, the broker sent a confirmation slip to the customer containing the disclosure required by the Securities and Exchange Commission (the SEC); however, the brokers did not disclose order flow payments.

Plaintiffs filed suits alleging claims for breach of fiduciary duty, unjust enrichment, unfair and deceptive business practices, and breach of contract based on the brokers' retention of the order flow payments.

ANALYSIS

"The purpose of a motion to dismiss under section 2-619 *** is to afford litigants a means to dispose of issues of law and easily proved issues of fact at the outset of a case, reserving disputed questions of fact for a jury trial." *Zedella v. Gibson,* 165 Ill. 2d 181, 185 (1995). All well-pleaded facts in the complaint are admitted, but conclusions of law and fact unsupported by specific allegations are not. *Draper v. Frontier Insurance*

Co., 265 Ill. App. 3d 739, 742 (1994). The trial court must construe the motion and supporting documents in the light most favorable to the nonmovant. *Draper*, 265 Ill. App. 3d at 742. "Section 2-619(a)(9) allows dismissal when 'the claim asserted *** is barred by other affirmative matter avoiding the legal effect of or defeating the claim.'" *Zedella*, 165 Ill. 2d at 185, quoting Ill. Rev. Stat. 1991, ch. 110, par. 2-619. Preemption is an affirmative matter. *Russo v. Boland*, 103 Ill. App. 3d 905, 909-10 (1982). "The question on appeal is 'whether the existence of a genuine issue of material fact should have precluded the dismissal or, absent such an issue of fact, whether dismissal is proper as a matter of law.'" *Zedella*, 165 Ill. 2d at 185-86, quoting *Kedzie & 103rd Currency Exchange, Inc. v. Hodge*, 156 Ill. 2d 112, 116-17 (1993). We review the trial court's decision *de novo*. *Kedzie*, 156 Ill. 2d at 116.

Congress promulgated the Act, which created the SEC and delegated to it the responsibility for oversight of the securities industry. Federal oversight was designed to: (1) protect the investing public; (2) remove impediments to smooth operation of the national market; and (3) impose reporting requirements that ensure a fair and honest market. *Dahl v. Charles Schwab & Co.*, 545 N.W.2d 918, 924 (Minn. 1996). In 1977, the SEC adopted Rule 10b-10, which outlined the necessary disclosure brokers were required to furnish their its clients. 17 C.F.R. 240.10b-10 (1994). Rule 10b-10 mandated brokers to furnish written notification at or before completion of a transaction, which included:

> "The source and amount of any other remuneration received or to be received by him in connec-

> tion with the transaction: Provided, however, *** the written notification may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer." 17 C.F.R. 240.10b-10(a)(7)(iii) (1994).

Originally, the rule made no specific reference to order flow payments.

The rule was amended effective October 2, 1995, which added disclosure requirements concerning order flow payments. The rule now states that brokers must provide customers with: "a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer." 17 C.F.R. 240.10b-10(a)(7)(iii) (1996). This disclosure must be made to the customer at the time the customer opens his or her account. 17 C.F.R. 240.11Ac1-3(a) (1996).

All of the acts giving rise to the instant case occurred prior to the 1995 amendment.

Plaintiffs contend the Act does not preempt state regulation of securities. They argue this is particularly true in light of section 28(a), which provides that "the rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. § 78bb(a) (1994). They further contend that the pre-1995 version of rule 10b-10 did not encompass order flow payments and, therefore, does not preempt state law.

The parties submit decisions from four jurisdictions, and independent research has disclosed no others. Three of the jurisdictions (New York, Minnesota, and California) find that federal law preempts state regulation of securities. Only the federal district courts for Louisiana hold that state claims based on state laws are not barred. All acts giving rise to each of these cases occurred prior to the 1995 amendment of rule 10b-10, as in the instant case.

Federal law may preempt state law either expressly or impliedly. No express preemption exists here. See *Dahl,* 545 N.W.2d at 923. Thus, if state claims are preempted, it must be by implication.

> "The United States Supreme Court has identified a two-pronged analysis for determining whether Congress made such an implication [(implied preemption)]. State law is preempted if Congress has entirely displaced the possibility of state regulation or if state regulation conflicts with federal law. [Citation.] The Court has indicated that four main considerations are relevant to an inquiry into whether Congress has impliedly displaced possible state regulation: 1) the scheme of federal regulation may be so pervasive as to leave no room for supplemental state action; 2) the federal interest may be so dominant that state regulation will be presumptively precluded; 3) the objective of the federal regulation may reveal a preemptive purpose; or 4) the state policy may produce a result inconsistent with that federal objective. [Citation.] State law will conflict with federal law when 'compliance with both federal and state regulations is a physical impossibility' or where state law 'stands

> as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" *Dahl,* 545 N.W.2d at 924, quoting *Pacific Gas & Electric v. State Energy Resources Comm'n,* 461 U.S. 190, 204, 75 L. Ed. 2d 752, 765, 103 S. Ct. 1713, 1722 (1983).

In *Guice v. Charles Schwab & Co.*, No. 200 (N.Y. October 17, 1996), the New York Court of Appeals held that plaintiffs' state claims were preempted. Plaintiffs argued defendants breached their fiduciary duties by retaining order flow payments without adequate disclosure. The court rejected this argument, finding the state claims preempted by the 1975 amendments to the Act as implemented by SEC regulations. The *Guice* court determined that the 1975 amendments granted the SEC authority to shape a *new* national market system, gave it power to regulate, and authorized it to police the new system. One of the goals of the 1975 amendments was to develop a "national market system for security trading" (*Guice*, slip op. at 17) which was to be policed by a "coherent and rational regulatory structure." *Guice*, slip. op. at 17. The SEC was directed to administer this structure, which it did through regulations. In furtherance of these goals, in 1977, the SEC adopted rule 10b-10, a uniform rule for all transactions in the national market. According to *Guice*, the SEC had monitored and studied the securities industry for years and consistently applied rule 10b-10 to order flow payments. The *Guice* court noted that the SEC amended rule 10b-10 after recognizing that order flow payments furthered purposes of Congress "by enhancing more efficient and less costly execution of customers' orders and by promoting competition." *Guice*, slip op. at 18. Although the amendment

occurred after the facts giving rise to the claims in *Guice*, the court implied that this amendment demonstrated the SEC's continued regulation of order flow payments.

Guice rejected plaintiffs' argument that section 28(a) foreclosed preemption of areas other than those explicitly listed in that section.

In finding preemption, the court reasoned that state claims would serve as an obstacle to federal goals and, thus, could not endure. It based its rationale on the legislative history of the 1975 amendments and the SEC's history of regulating order flow payments. First, the court was:

> "[C]onvinced that permitting the courts of each State to enforce [their] common-law agency standards of disclosure on the practice of order flow payments *** would unavoidably result in serious interference with the 'accomplishment and execution of the full purposes and objectives of Congress' [citation], in enacting the 1975 amendments, and would directly conflict with SEC regulations limiting the disclosure requirements regarding receipt of order flow payments ***." *Guice*, slip op. at 16-17.

Likewise:

> "Permitting the courts of each State to impose civil liability on national securities brokerage firms, ***, for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments (rather than the federally-mandated *uniform* specific disclosure ***) would inevitably defeat the congressional purpose of enabling the SEC to develop and

> police that 'coherent regulatory structure' for a national market system." (Emphasis in original.) *Guice*, slip op. at 18.

If each state were allowed to specify the nature of disclosure, brokerage firms would be required to tailor their disclosure statements to each state's law and the "carefully-crafted SEC disclosure requirements would have little, if any, influence." *Guice*, slip op. at 19. Because the state law would adversely affect the SEC's ability to regulate uniformly, the state law was preempted.

The *Guice* court also determined the objectives of Congress would be thwarted in a second way: order flow payments would be eliminated. "At worst, onerous stricter disclosure costs plus the threat of lawsuits all around the country, based on breach of common-law agency relationships, would likely result in many brokerage firms abandoning acceptance of order flow payments altogether, an even more drastic undermining of congressional objectives." *Guice*, slip op. at 20. The SEC clearly authorizes the use of order flow payments and recognizes its benefit to the industry. Any activity that defeats this goal is an obstacle to federal law.

In sum, the court stated:

> "The stricter standards of order flow payment disclosure which may be required under State common-law agency principles inevitably will supplant the disclosure rules of the SEC on the same subject and come to dominate the relationship between broker and customer *** [thus] upset[ting] the policy-based delicate balance Congress directed the SEC to achieve in the regulatory regime envisaged under the 1975

> amendments to the Securities Exchange Act." *Guice*, slip op. at 21-22.

In *Dahl,* 545 N.W.2d 918, the Minnesota Supreme Court ruled that the SEC rules preempted plaintiffs' state common and statutory law actions. Before stating its rationale for finding preemption, the court rejected several of the parties' arguments, which correspond to arguments raised in the instant case. First, it rejected plaintiffs' argument that only those areas specifically identified in section 28(a), and no others, were preempted, stating that the savings clause provision in section 28 did "not prevent implied preemption of areas of securities law not specified in the clause." *Dahl,* 545 N.W.2d at 923. Second, it rejected defendants' argument that the pre-1995 version of rule 10b-10 expressly preempted state law. The *Dahl* court stated that the "SEC *** had no rule in place expressly mentioning order flow payments." *Dahl,* 545 N.W.2d at 923. Third, it concluded that rule 10b-10 as amended in 1995 did not apply since it was not in effect at the time the trades giving rise to the claims in *Dahl* were conducted.

The *Dahl* court found implied preemption, based on state laws being an obstacle to federal goals. Because the securities industry is not only national, but also international, the *Dahl* court asserted that a decision by any particular state court would reach beyond the state's border. Thus, although it would be possible for brokers to comply with both state and federal disclosure regulations, individual disclosure requirements would frustrate the federal objectives. In *Dahl*, as in the case before us, plaintiffs sought to impose a duty upon brokers to either obtain the consent of the customer to retain order flow payments *prior* to a transaction, or to

remit the payments to customers. Defendants contended, as do they in the instant case, that such a requirement would in effect lead to the extinction of order flow payments. The court agreed with defendants.

> "For Schwab to fully comply with these state agency law requirements, it would need to be able to ascertain the exact amounts of these profits [order flow payments] in order to seek its clients' consent, or to remit them to its customers if consent were withheld. Since it cannot parse out order flow payments to such a degree, compliance with the potential consent requirements of Minnesota law might put an end to the practice of order flow payments, which is allowed under federal law. Thus, the remedy [customers] seek could frustrate the objectives of the SEC and Congress." *Dahl,* 545 N.W.2d at 925.

Finally, in *McKey v. Charles Schwab & Co.*, No. BC139314 (Cal. Super. Ct. September 10, 1996), and *Miller v. Charles Schwab & Co.*, No. BC137133 (Cal. Super. Ct. September 10, 1996), the superior court of California for Los Angeles County found plaintiffs' state claims preempted. It too noted that the pre-1995 version of rule 10b-10 is part of an overall regulatory scheme which would be frustrated by allowing individual state adjudication of disclosure requirements. According to this court, "[i]t strikes the Court as poor public policy to create confusion, by allowing a proliferation of common law disclosure standards, from California and presumably 49 other states, in the interest of protecting an intangible principle of 'better disclosure' where there is no tangible damage." *McKey*, slip op. at 1. In sum, the "additional standards proposed by *** plaintiff[s] would

stand as an obstacle to the federal regulatory scheme." *McKey*, slip op. 1.

Conversely, the federal districts courts for both the Eastern and Western District of Louisiana have held that state claims are not preempted. *Thomas v. Charles Schwab & Co.*, No. 95-0307 (W.D. La. July 12, 1995); *Dumont v. Charles Schwab & Co.*, No. 95-0606 (E.D. La. May 4, 1995).

In *Thomas*, the court stated "Congress has not expressly preempted state law and, after a review of the record, this court finds that congressional intent to preempt state law cannot be inferred." *Thomas*, slip op. at 3. *Thomas* concluded:

> "[A]dditional disclosure regarding 'amount of renumeration [sic]' and that 'the renumeration [sic] was paid by a party whose interests are adverse to those of the customer' will not conflict with this SEC regulation nor act as an obstacle to the protection of a fair competitive market and investor interests.
>
> In addition, defendant has not persuaded this court that it was Congress' intent to provide comprehensive regulation dealing with the disclosure of order flow payments to the exclusion of all state laws regarding agency and fiduciary duties." *Thomas*, slip op. at 4.

In *Dumont*, the court determined that section 28(a) neither expressly preempted state law nor demonstrated a pervasive federal regulatory scheme. Based on this finding, the court stated:

> "Where as here, Congress has not explicitly or implicitly displaced all state regulation in a specified field, preemption arises only if compli-

> ance with both federal and state law is an impossibility or when the state law is an obstacle to the accomplishment of the purposes of the federal scheme. Although applying the Louisiana standard of fiduciaries to a national brokerage company such as Schwab may require a stricter standard of care to its customers, the application of Louisiana law does not conflict with the SEC's authority and power to regulate the securities industry, and compliance with both federal regulations and the stricter Louisiana standard of care is not impossible. Moreover, since greater disclosure could benefit the investor, the applicable of Louisiana law may indeed serve the basic purpose of federal laws and regulations. *Dumont*, slip op. at 4.

We find the decisions from New York, Minnesota, and California persuasive. Each extensively discussed the history and scheme of the securities market and federal participation in it. As all of them commented, the securities industry is a national market which must be regulated uniformly. To allow plaintiffs' causes of action to survive in the Illinois state courts, the federal uniformity goal will be frustrated, if not destroyed. If different state disclosure requirements must be met by brokerage firms across the nation, uniformity will not exist. If uniformity is not to prevail, neither rule 10b-10 nor the SEC would serve any function or purpose in regulating disclosure. Accordingly, the goals of the federal government would be frustrated. While stricter disclosure requirements may be advantageous, as rule 10b-10 now requires, the SEC's amendment of the rule demonstrates its intent to regulate the area and to set forth the necessary disclosure requirements.

While we agree with *Thomas* and *Dumont* that state disclosure regulations may not directly conflict with federal law, we do not agree with their conclusions that state law is no obstacle to the federal goals. Although stricter disclosure may serve the federal goal of protecting investors, the *Dumont* court ignores the fact that the law of Louisiana may be different than the laws of the 49 other states. It gives no rationale regarding the lack of uniformity among the states nor the affect different laws would have on the securities industry. The *Thomas* court looked only to and was concerned with the law of Louisiana. Additionally, the *Thomas* court cites no authority in support of its decision and fails to discuss or even address rule 10b-10 except in passing. The court in *Dumont* relied on section 28(a), with only a brief discussion of rule 10b-10, and provided little, if any, basis for its decision. Thus, we find *Thomas* and *Dumont* unconvincing.

For these reasons and those additional reasons outlined in *Guice* and *Dahl*, we conclude plaintiffs' claims were barred by federal preemption, thus, defeating them. Consequently, the trial court properly dismissed plaintiffs' complaints as a matter of law.

For the foregoing reasons, the decision of the circuit court of Cook County is affirmed.

Affirmed.

McNAMARA, J., concurs.

ZWICK, P.J., dissents.

Justice ZWICK, dissenting:

The majority concludes that common law agency principles are implicitly pre-empted by the implementation by the Securities and Exchange Commission Rule 10b-10. They reach this conclusion by adopting the sweeping and erroneous premise that "the securities industry is a national market which must be regulated uniformly." Slip op. at 15. In my view, the majority has gotten it exactly backwards. The disclosure by an agent to his principle that he is earning additional renumeration [sic] or a "kickback" does nothing to interfere with uniform regulation of the securities industry.

In passing the securities laws, Congress deliberately created a *dual* system of regulation in which *both* federal and state laws govern industry participants, so long as state regulation is not inconsistent with federal law. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware,* 414 U.S. 117, 137, 94 S. Ct. 383, 38 L. Ed. 2d 348 (1973). Section 28(a) of the Exchange Act could not be clearer: "[t]he rights and remedies provided by this title shall be *in addition to* any and all other rights and remedies that may exist at law or in equity." 15 U.S.C. 78bb(a) (Emphasis added). To this end, Rule 10b-10 was promulgated by the SEC in 1977 to set forth the *minimum* disclosure requirements, not displace those disclosures required by the common law.

Rule 10b-10 is entitled "Confirmation of Transactions" and sets forth various disclosures that a broker or dealer must make to customers in writing at or before the completion of certain transactions. In the release announcing the adoption of the Rule, the SEC stated in pertinent part:

> "The rule does not attempt to set forth all possible categories of material information to be disclosed by broker-dealers in connection with a particular transaction in securities. Rule 10b-10 only mandates the disclosure of information which can generally be expected to be material. Of course, in particular circumstances, additional information may be material and disclosure may be required."

Securities Exchange Act Release No 13,508 [1977-1978 Decisions] Fed. Sec. L. Rep. (CCH) Par. 81,143, at 87,930 n. 28 (May 5, 1977). Thus, Rule 10b-10 was never intended to serve as a "safe harbor."

Throughout the process of adopting, and then amending, Rule 10b-10, the Securities and Exchange Commission has maintained the position that additional disclosure beyond the SEC rules may be required. See e.g., *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith*, 835 F.2d 1031, 1035 (3rd Cir. 1987). Although the SEC ultimately adopted a safe harbor for brokers and dealers in Rule 11Ac1-3 (17 C.F.R. § 240.11Ac1-3), which provides a mechanism pursuant to which brokers and dealers can effectively disclose payment for order flow concerns to customers *prior* to the establishment of a agent/principal relationship, it is important to keep in mind that this new Rule was *not* in effect at the time the transactions now at issue took place. Rule 11Ac1-3, therefore, is simply not relevant to the plaintiffs' claims or to our preemption analysis.

If the allegations of plaintiffs' complaint are taken as true, as they must be at this stage of the proceedings, it is clear that the plaintiffs have alleged a valid cause of action. This case is indistinguishable from *Janes v. First*

Federal Savings and Loan Ass'n, 57 Ill. 2d 398, 312 N.E.2d 605 (1974), in which a lender that obtained title insurance for its customers and then received rebates from the title company for sending it the business was held to have a fiduciary duty to pass the rebate money on to the customers. The supreme court noted that, "unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal." *Janes,* 57 Ill. 2d at 410, 312 N.E.2d 605, quoting Restatement (Second) of Agency, § 388. There are any number of similar opinions, from Illinois as well as from other jurisdictions, stating this same long-standing and fundamental agency principle.

The prior disclosures required by the common law for an agent to keep the type of "kickbacks" that order flow payments represent in no way represents an obstacle to the federal goal of establishing an efficient and equitable national market. If brokers and dealers wish to earn a profit in executing their clients orders in addition to their bargained-for commissions, all that the common law requires is for brokers and dealers to disclose this additional renumeration [sic] prior to entering into the agency relationship with their clients, as Rule 11Ac1-3 now contemplates. In that they hold otherwise, the cases relied upon by the majority are wrongly decided.

The *Guice* court reasoned that since the 1975 amendments to the Securities Exchange Act were designed, in part, to create a "uniform" national market, the SEC must have intended to promote a "uniform" rule for order flow payments when it promulgated Rule 10b-10 in 1977. Yet my research indicates that payment for

order flow is a fairly recent practice which grew up *after* the SEC's promulgation of Rule 10b-10 in 1977. Order flow payments appear to have first come to the attention of the news media and the National Association of Securities Dealers only in 1985. See *Note, The Perils of Payment for Order Flow*, 107 Harv. L.Rev. 1675, 1676, fn. 8 (1994); Jane Sasseen, *Dirty Little Secret,* Forbes, June 17, 1985, at 203. It follows that payment for order flow by brokers could not have been contemplated or specifically regulated in 1977 by Rule 10b-10 when the SEC promulgated the rule. It is not surprising, therefore, that the 1976 SEC release asking for public comment on then proposed Rule 10b-10 does not mention payment for order flow. Instead, the release explains that the proposed rule is designed to deal with a quite different problem, namely, "with agency crosses in the over-the-counter market where the broker acts as agent for *both* the buyer and the seller." SEC Proposed Rulemaking, Exchange Act Release No. 12806 (Sept. 16, 1976) (Emphasis added.) Similarly, the 1977 SEC release which accompanied the final rule discusses how the rule would be applied when a brokerage firm represents the buyer and seller in the same transaction. Exchange Act Release No. 13508 (May 5, 1977).

The Minnesota Supreme Court's recent opinion in *Dahl* is no more compelling. The *Dahl* court concludes that, "For [defendant] Schwab to fully comply with these state agency law requirements, it would need to be able to ascertain the exact amounts of these profits in order to seek its clients' consent, or to remit them to its customers if consent were withheld." *Dahl,* 545 N.W.2d at 925. This conclusion is unsupported by agency law, logic or the record in our case.

An agency is a consensual relationship. *State Security Insurance Co. v. Frank B. Hall & Co.*, 258 Ill. App. 3d 588, 595, 196 Ill. Dec. 775, 630 N.E.2d 940 (1994). As such, the relationship can be modified by mutual agreement as the parties see fit. All the defendants need have done to comply with the common law is to have informed their clients that, as a condition of accepting client business, the defendants would insist on retaining any order flow payments received in connection with the execution of client orders. Defendants elected not to do so. If the defendants now believe they have an onerous obligation under the common law to refund order flow payments, I can only conclude that they have brought this obligation upon themselves by not fully informing their clients of the true nature of their renumeration [sic].

For the above reasons, I respectfully dissent.

IN THE CIRCUIT COURT OF
COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

GORDON RUBENSTEIN,	)	
	)	
Plaintiff,	)	
	)	
versus	)	No. 94 CH 1446
	)	
	)	
QUICK & REILLY, INC. and U.S. CLEARING CORP.,	)	
	)	
	)	
Defendants.	)	

ORDER

This Cause, coming on to be heard upon the **MOTION TO DISMISS** of the defendants, **QUICK & REILLY, INC. and U.S. CLEARING CORP.**, due notice having been given and the court being fully advised in the premises;

IT IS HEREBY ORDERED:

That Defendants' Motion to Dismiss is hereby granted;

Further this court finds no just cause for delay of enforcement or appeal.

/s/ Judge Arthur L. Dunne
Circuit Court Judge

Dated: September 27, 1994

IN THE CIRCUIT COURT OF
COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

ROBERT ORMAN, Plaintiff,	)	
versus	)	No. 93 CH 7365
CHARLES SCHWAB & CO., INC., Defendant.	)	

ORDER

This cause coming on to be heard on motion of defendant to dismiss the complaint, due notice having been given, the parties having appeared and argued the motion, it is hereby ordered:

That defendant's motion to dismiss be and is GRANTED. This court having determined that plaintiff's claims are preempted by federal law and having adopted the opinion of the District Court of Hennepin County, Minnesota in that complaint styled DAHL v. CHARLES SCHWAB & COMPANY.

Further that this court finds no just cause for delay of enforcement or appeal of this order.

/s/ Judge Edward C. Hofert
Circuit Court Judge

Dated: June 2, 1994

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS

1. FEDERAL CONSTITUTIONAL PROVISION.

The Supremacy Clause, U.S. Constitution, Article VI, clause 2, provides:

> This Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land; and the Judges of every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

2. FEDERAL SECURITIES LAWS.

Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb, reads, in relevant part:

> 78bb. Effect on existing law
>
> Addition of rights and remedies; recovery of actual damages; State securities commissions
>
> (a) The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

3. RULES OF THE SECURITIES AND EXCHANGE COMMISSION.

17 C.F.R. § 240.10b-10 (promulgated 1977), Rule 10b-10, Confirmation of Transactions:

(a) It shall be unlawful for any broker or dealer to effect for or with an account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security (other than U.S. Savings Bonds or municipal securities) unless such broker or dealer, at or before completion of such transaction gives or sends to such customer written notification disclosing—

* * *

(2)(i) If the broker or dealer is acting as an agent for such customer, for some other person, or for both such customer and some other person,

* * *

(7)(iv) The source and amount of any other remuneration . . . received by him in connection with the transaction: Provided, however, that if, in the case of a purchase, the broker was not participating in a distribution, or in the case of a sale, was not participating in a tender offer, written notification may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer.

§ 240.10b-10 (amended 1994) – Confirmation of transactions.

(a)* * *

(7)* * *

(iii) For a transaction in any subject security as defined in § 240.11Ac1-2 or a security authorized for quotation on an automated interdealer quotation system that has the characteristics set forth in Section 17B of the Act (15 U.S.C. 78q-2), a statement whether payment for order flow is received by the broker or dealer for transactions in such securities and that the source and nature of the compensation received in connection with the particular transaction will be furnished upon written request of the customer; and

17 C.F.R. 240.11Ac1-3 (adopted 1994)

Rule 11Ac1-3. Customer Account Statements.

(a) No broker or dealer acting as an agent for a customer may effect any transaction in, induce or attempt to induce the purchase or sale of, or direct orders for purchase or sale of, any subject security as defined in §240.11Ac1-2 or a security authorized for quotation on an automated interdealer quotation system that has the characteristics set forth in section 17B of the Act (15 U.S.C. 78q-2), unless such broker or dealer informs such customer, in writing, upon opening a new account and on an annual basis thereafter, of the following:

(1) The broker's or dealer's policies regarding receipt of payment for order flow as defined in § 240.10b-10(e)(9), from any broker or dealer, national securities exchange, registered securities association, or exchange member to which it routes customers' orders for execution, including a statement as to whether any payment for

order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and

(2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow as defined in § 240.10b-10(e)(9) absent specific instructions from customers, including a description of the extent to which orders can be executed prices superior to the best bid or best offer as defined in § 240.11Ac1-2.